

State Board of Equalization
OPERATIONS MEMO
For Public Release

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SUBJECT: 40% Evasion Penalty: Failing to Report Sales or Use Tax Reimbursement

I. PURPOSE

This operations memo provides guidelines and procedures for the implementation of Revenue and Taxation Code (RTC) section 6597, enacted by Senate Bill 1449 (Chapter 252, Statutes of 2006). This section imposes a 40-percent evasion penalty on any person who knowingly collects sales tax reimbursement (as defined by Civil Code section 1656.1) or who knowingly collects use tax, and fails to timely remit that sales tax reimbursement or use tax ("tax") to the Board.

The 40-percent evasion penalty is discretionary and should only be applied **for the most egregious cases** where the taxpayer has not submitted a credible explanation showing the failure to comply was due to reasonable cause or circumstances beyond the taxpayer's control and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect. Section 6597 is operative January 1, 2007, and applies to reporting periods beginning on and after that date.

II. BACKGROUND

Sales and Use Tax Regulation 1700, *Reimbursement for Sales Tax*, implements Civil Code section 1656.1 and provides that the terms of the agreement of the sale govern whether the retailer may add sales tax reimbursement to the sales price of the tangible personal property sold at retail. It is presumed the parties agreed to the addition of sales tax reimbursement to the sales price of tangible personal property if:

- A. The agreement of sale expressly provides for such addition of sales tax reimbursement;
- B. Sales tax reimbursement is shown on the sales check or other proof of sale; or
- C. The retailer posts at his or her premises in a location visible to purchasers, or includes on a price tag or in an advertisement or other printed material directed to purchasers, a notice to the effect that reimbursement for sales tax will be added to the sales price of all items or certain items, whichever is applicable.

It is also presumed the gross receipts from the retail sale of tangible personal property include sales tax reimbursement if the retailer posts in his or her premises, or includes on a price tag or in

an advertisement, whichever is applicable, a notice stating that the price of the item or price of taxable items includes sales tax reimbursement.

RTC section 6597 provides that sales tax reimbursement also includes any sales tax that is advertised, held out, or stated to the public or to any customer, directly or indirectly, that the tax or any part thereof will be assumed or absorbed by the retailer.

For purposes of the sales tax, section 6453 requires sellers to file returns showing their gross receipts during the preceding reporting period. For the purposes of the use tax, retailers must file returns showing the total sales price of the property sold by him or her, the storage, use or consumption of which property became subject to use tax during the preceding reporting period. The return must show the amount of taxes for the period covered by the return and any other information which the Board deems necessary for the proper administration of this part. Section 6481 provides that if the Board is not satisfied with a return or returns of the tax or the amount of tax, it may compute and determine the amount required to be paid upon the basis of the facts contained in the return or returns, or upon the basis of any information within its possession. One or more deficiency determinations may be made of the amount due for one or for more than one period.

III. APPLICATION OF PENALTY

- | Except when relief is warranted, the 40-percent evasion penalty may apply to any person as defined by Revenue and Taxation Code section 6005 who knowingly collects sales tax reimbursement or use tax and fails to timely report and pay the amounts collected to the Board. The provisions of section 6597 apply to any determination made by the Board pursuant to Article 2 (commencing with section 6481), Article 3 (commencing with section 6511) and Article 4 (commencing with section 6536) of Chapter 5 of the Sales and Use Tax Law. As such, the penalty does not apply to taxpayer self-assessed tax liabilities. The penalty applies only to amounts representing sales tax reimbursement or use tax collected and not timely remitted and the penalty applies only in the specific time period(s) in which the underreporting occurred. The penalty does not apply to estimated or projected liabilities, but only to liabilities determined on an actual basis.

Pursuant to section 6597, if the liability for the unremitted tax reimbursement averages \$1,000 or more per month for the reporting period, **and** exceeds 5 percent of the total tax collected in the same quarter in which the tax was due, the penalty may be applied. However, the penalty does not apply if both thresholds are not met.

- | The following examples illustrate the application of the evasion penalty.

Example 1

During a quarterly reporting period, a taxpayer's total tax collected is \$10,000, as determined by an audit investigation. The taxpayer remits \$7,500 of the tax collected. The total unremitted tax is \$2,500. The average monthly unremitted tax is \$833 ($\$2,500 \div 3$ months), which does not exceed \$1,000 per month. Since the average monthly unremitted tax is less than \$1,000 per month, the 40-percent penalty imposed pursuant to section 6597 does not apply.

Example 2

During a quarterly reporting period, a taxpayer's total tax collected is \$500,000, as determined by an audit investigation. The taxpayer remits \$480,000 of the tax collected. The total unremitted tax is \$20,000. The average monthly unremitted tax is \$6,666 ($\$20,000 \div 3$ months), which exceeds \$1,000 per month. However, five percent of the total amount of tax collected in the same quarter in which the tax was due is \$25,000 ($\$500,000 \times .05$), which is more than the total unremitted tax of \$20,000. Since the unremitted tax amount (\$20,000) does not exceed 5 percent (\$25,000) of total tax reported in the same quarter in which the tax was due, the 40-percent penalty does not apply.

Example 3

During a quarterly reporting period, a taxpayer collected \$22,000 in tax but remitted only \$10,000, as determined by an audit investigation. The total unremitted tax is \$12,000. The average monthly unremitted tax is \$4,000 ($\$12,000 \div 3$ months), which exceeds \$1,000 per month, and five percent of the total tax collected in the same quarter in which the tax was due is \$1,100 ($\$22,000 \times .05$). Since the average monthly unremitted tax (\$4,000) exceeds **both** the \$1,000 per month **and** the five percent of the total tax collected in the same quarter in which the tax was due (\$1,100), the 40-percent evasion penalty may be applied to the \$12,000 liability, unless the failure to remit the tax when due was due to reasonable cause or circumstances beyond the person's control (i.e., the Board lacks clear and convincing evidence that the person's otherwise reasonable explanation for failing to remit the tax is false, as discussed below).

If the liability for the unremitted tax averages \$1,000 or more per month, and exceeds 5 percent of the total tax reported in the same quarter in which the tax was due, the penalty may apply unless a **credible** explanation is presented which shows failure to timely remit the tax was due to reasonable cause or circumstances beyond the person's control and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect, including, but not limited, to the following reasons provided by RTC section 6597:

1. The occurrence of a death or serious illness of the person or the person's next of kin;
2. The occurrence of an emergency as defined by Government Code section 8558, e.g., a state of war emergency or a "duly proclaimed" state of emergency or local emergency;
3. A natural disaster or other catastrophe directly affecting the person's business operations;
4. The Board failed to send returns or other information to the correct address of record;
5. The person's failure to timely remit the tax occurred only once over a 3-year period, or once during the period in which the person was engaged in business, whichever period is shorter; or
6. The person voluntarily corrected the errors in remitting the tax in prior periods and remitted or initiated payment of the liability prior to being contacted by the Board.

When a taxpayer provides an explanation for failing to remit the tax, it will be the District Administrator's responsibility to consider the credibility of the explanation. The District Administrator will evaluate the taxpayer's explanation within the context of the criteria provided above to determine whether there are sufficiently compelling reasons to justify the taxpayer's failure to remit the tax. Unless there is clear and convincing evidence that refutes the taxpayer's explanation for failing to remit the tax, staff should accept the explanation as meeting the taxpayer's burden of proof that their failure to timely remit the tax was due to reasonable cause and or circumstances beyond their control. The auditor must document the explanation on the Form 414-A, *Report of Field Audit*, or Form 414-B, *Field Billing Order*, as applicable.

As with other evasion penalties, the application of the 40-percent penalty can extend the time for which determinations can be made beyond the otherwise applicable statute of limitations set forth in section 6487. The intent demonstrated by the taxpayer to knowingly withhold the tax collected, is sufficient to assess the tax and impose the 40-percent evasion penalty for prior periods, provided those reporting periods in which the taxpayer understated his or her tax liability are after January 1, 2007.

IV. MULTIPLE PENALTIES

Two or more evasion penalties may not be added to the same deficiency determination when the penalties apply to the same series of acts in the same periods. Likewise, the 40-percent evasion penalty for knowingly collecting tax and failing to properly remit it will not apply to transactions for which a fraud or other evasion penalty has already been assessed in the same period. However, in some instances, more than one penalty may apply to the same transaction. For example, a 10-percent penalty for failure to file a return may be applied in conjunction with the 40-percent evasion penalty provided under section 6597. In addition, when the 40-percent evasion penalty is applied, other penalties, such as 10-percent negligence penalty or the 25-percent fraud penalty may apply to the same liability period, but not the same transactions for which the 40-percent evasion penalty was applied. Also, while most penalties apply to the entire tax portion of a determination, the 40-percent penalty only applies to the unremitted tax in the periods of a liability where the taxpayer knowingly collected and failed to remit the tax, and the unremitted tax was established on an actual basis.

Since the provisions of section 6597 apply to reporting periods commencing on or after January 1, 2007, liabilities subject to the 40-percent evasion penalty are not subject to amnesty penalties.

V. DISTRICT RESPONSIBILITIES

Penalty Recommendation Memo

Approval to recommend the penalty must be obtained from the District Administrator after the audit has been reviewed. In every instance where the penalty provided by section 6597 is recommended by the District Administrator, the audit report and working papers must be accompanied by a memorandum to the Chief, Headquarters Operations Division, from the District Administrator. The District Administrator or designee must sign the memorandum. A copy of the memorandum must also be forwarded to the appropriate Chief in the Field

Operations Division. The memorandum must stand on its own and include in detail all of the facts and circumstances to support the section 6597 penalty recommendation. The facts and circumstances should be the same as those provided in the audit working papers and must cover any periods outside the statute of limitations. Any confidential evidence that is not included in the audit working papers must be attached to the memorandum. If an audit includes related taxpayers, a separate memorandum must be prepared for each taxpayer for whom the auditor recommends a section 6597 penalty.

If approved by the Chief, Headquarters Operations Division, the memorandum will be returned to the district to provide a copy of the approved memorandum to the taxpayer. A copy of the memorandum should not be provided to the taxpayer or taxpayer's representative until it is approved by the Chief, Headquarters Operations Division.

Audit Report - Penalty Information

If the penalty is applied, auditors must include a comment on the back of the Form BOE-414-A, *Report of Field Audit*, indicating that the 40-percent evasion penalty is recommended for knowingly collecting sales tax reimbursement or use tax and not timely remitting the tax. Audit staff must also indicate on the front of the 414-A: "Penalty of 40% has been added for unremitted tax collected." When preparing the Schedule 12, the auditor must schedule all taxable measure subject to the 40-percent evasion penalty under the error description heading of "Unremitted Tax Collected" (UTC) with a noncompliance code of 2301. All other additional taxable measure should be categorized under the noncompliance code that adequately describes the area of error and scheduled accordingly. On form BOE-767, *Tax, Penalty, and Interest Calculation*, the auditor will add the comment "Penalty of 40% has been added for unremitted tax collected," in the *Penalty Comments* section. The auditor must also enter "UTC" in the *Penalties to be applied for all Periods* section. IRIS will automatically calculate the UTC penalty on the measure entered in noncompliance code 2301. Additionally, the audit control staff will enter Line Item Number 23 on the Noncompliance screen and the code "UTC" on the Principal and Interest screen in IRIS.

Currently IRIS does not provide a 40-percent **offset** penalty for audits with an SG credit. The auditor must add a comment on the back of the 414-A notifying the Audit Determination and Refund Section (ADRS) that an SG credit is available for offset.

VI. HEADQUARTERS' RESPONSIBILITIES

Headquarters Operations Division

As with all evasion penalties, the Chief, Headquarters Operations Division, is responsible for reviewing and approving or denying all recommendations to impose section 6597 penalties. The Chief will prepare a memorandum to the attention of the District Administrator when the recommendation to impose the penalty is denied.

VII. RELIEF OF PENALTY

After the Notice of Determination is issued, Form BOE-735, *Request for Relief from Penalty*, is available for use by taxpayers when requesting relief from a section 6597 penalty. The use of this form is not required but it is recommended. Forms may be provided to taxpayers only after the penalty is approved by the Chief, Headquarters Operations Division. All requests for relief of section 6597 penalty must be in writing, signed under penalty of perjury, and include the following:

1. The taxpayer's name and account number;
2. The applicable period for which relief is requested and the dollar amount;
3. A statement explaining how the person's failure to timely remit the tax was due to reasonable cause or circumstances beyond the person's control.

The request for relief will be placed on the Board's calendar as an agenda item and the Board Members will vote on whether to approve or deny the request for relief of the 40-percent evasion penalty. Requests for penalty relief must set forth the facts upon which the claim for relief is based and any other information the Board Members may require. It should be noted that the Board Members may consider any evidence submitted by taxpayers to determine whether the person's failure to remit the tax timely was due to reasonable cause or circumstances beyond the person's control. In reaching the decision on whether to grant relief from section 6597 penalty, the Board Members' consideration of the evidence provided is not limited to the examples provided by section 6597. All denials of requests to grant relief from section 6597 penalty will be handled through the petition/appeal process. In this case, taxpayers must file a Petition for Redetermination rather than a second request for relief of penalty.

VIII. OBSOLESCENCE

This Operations Memo will become obsolete when the information contained herein is incorporated into the appropriate manuals.



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